

## § 240.15c3-4

(3) Debit balances in customers' cash and margin accounts included in the formula under item 10 shall be reduced by an amount equal to 1 percent of their aggregate value.

(4) Debit balances in cash and margin accounts of household members and other persons related to principals of a broker or dealer and debit balances in cash and margin accounts of affiliated persons of a broker or dealer shall be excluded from the Reserve Formula, unless the broker or dealer can demonstrate that such debit balances are directly related to credit items in the formula.

(5) Debit balances in margin accounts (other than omnibus accounts) shall be reduced by the amount by which any single customer's debit balance exceeds 25% (to the extent such amount is greater than \$50,000) of the broker-dealer's tentative net capital (i.e., net capital prior to securities haircuts) unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the Reserve Formula. Related accounts (e.g., the separate accounts of an individual, accounts under common control or subject to cross guarantees) shall be deemed to be a single customer's accounts for purposes of this provision.

If the registered national securities exchange or the registered national securities association having responsibility for examining the broker or dealer ("designated examining authority") is satisfied, after taking into account the circumstances of the concentrated account including the quality, diversity, and marketability of the collateral securing the debit balances or margin accounts subject to this provision, that the concentration of debit balances is appropriate, then such designated examining authority may grant a partial or plenary exception from this provision.

The debit balance may be included in the reserve formula computation for five business days from the day the request is made.

(6) Debit balances of joint accounts, custodian accounts, participations in hedge funds or limited partnerships or similar type accounts or arrangements of a person who would be excluded from the definition of customer ("non-customer") which persons includible in the definition of customer shall be included in the Reserve Formula in the following manner: if the percentage ownership of the non-customer is less than 5 percent then the entire debit balance shall be included in the formula; if such percentage ownership is between 5 percent and 50 percent then the portion of the debit balance attributable to the non-customer shall be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula; if such percentage ownership is greater than 50 percent, then the entire debit balance shall be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula.

NOTE F. Item 13 shall include the amount of margin required and on deposit with Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities.

NOTE G. (a) Item 14 shall include the amount of margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) for customer accounts to the extent that the margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities.

(b) Item 14 shall apply only if the broker or dealer has the margin related to security futures products on deposit with:

(1) A registered clearing agency or derivatives clearing organization that:

(i) Maintains the highest investment-grade rating from a nationally recognized statistical rating organization; or

(ii) Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits. For purposes of this Note G, the term "security deposits" refers to a general fund, other than margin deposits or their equivalent, that consists of cash or securities held by a registered clearing agency or derivative clearing organization; or

(iii) Maintains at least \$3 billion in margin deposits; or

## 17 CFR Ch. II (4-1-13 Edition)

(iv) Does not meet the requirements of paragraphs (b)(1)(i) through (b)(1)(iii) of this Note G, if the Commission has determined, upon a written request for exemption by or for the benefit of the broker or dealer, that the broker or dealer may utilize such a registered clearing agency or derivatives clearing organization. The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances, if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors; and

(2) A registered clearing agency or derivatives clearing organization that, if it holds funds or securities deposited as margin for security futures products in a bank, as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), obtains and preserves written notification from the bank at which it holds such funds and securities or at which such funds and securities are held on its behalf. The written notification shall state that all funds and/or securities deposited with the bank as margin (including customer security futures products margin), or held by the bank and pledged to such registered clearing agency or derivatives clearing agency as margin, are being held by the bank for the exclusive benefit of clearing members of the registered clearing agency or derivatives clearing organization (subject to the interest of such registered clearing agency or derivatives clearing organization therein), and are being kept separate from any other accounts maintained by the registered clearing agency or derivatives clearing organization with the bank. The written notification also shall provide that such funds and/or securities shall at no time be used directly or indirectly as security for a loan to the registered clearing agency or derivatives clearing organization by the bank, and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. This provision, however, shall not prohibit a registered clearing agency or derivatives clearing organization from pledging customer funds or securities as collateral to a bank for any purpose that the rules of the Commission or the registered clearing agency or derivatives clearing organization otherwise permit; and

(3) A registered clearing agency or derivatives clearing organization that establishes, documents, and maintains:

(i) Safeguards in the handling, transfer, and delivery of cash and securities;

(ii) Fidelity bond coverage for its employees and agents who handle customer funds or securities. In the case of agents of a registered clearing agency or derivatives clearing organization, the agent may provide the fidelity bond coverage; and

(iii) Provisions for periodic examination by independent public accountants; and

(4) A derivatives clearing organization that, if it is not otherwise registered with the Commission, has provided the Commission with a written undertaking, in a form acceptable to the Commission, executed by a duly authorized person at the derivatives clearing organization, to the effect that, with respect to the clearance and settlement of the customer security futures products of the broker-dealer, the derivatives clearing organization will permit the Commission to examine the books and records of the derivatives clearing organization for compliance with the requirements set forth in § 240.15c3-3a, Note G. (b)(1) through (3).

(c) Item 14 shall apply only if a broker or dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the broker or dealer has on deposit margin related to securities future products meets the conditions of this Note G.

[42 FR 27224, May 27, 1977, as amended at 50 FR 41340, Oct. 10, 1985; 52 FR 30334, Aug. 14, 1987; 69 FR 54190, Sept. 7, 2004]

## § 240.15c3-4 Internal risk management control systems for OTC derivatives dealers.

(a) An OTC derivatives dealer shall establish, document, and maintain a system of internal risk management controls to assist it in managing the

## Securities and Exchange Commission

## § 240.15c3-4

risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.

(b) An OTC derivatives dealer shall consider the following when adopting its internal control system guidelines, policies, and procedures:

(1) The ownership and governance structure of the OTC derivatives dealer;

(2) The composition of the governing body of the OTC derivatives dealer;

(3) The management philosophy of the OTC derivatives dealer;

(4) The scope and nature of established risk management guidelines;

(5) The scope and nature of the permissible OTC derivatives activities;

(6) The sophistication and experience of relevant trading, risk management, and internal audit personnel;

(7) The sophistication and functionality of information and reporting systems; and

(8) The scope and frequency of monitoring, reporting, and auditing activities.

(c) An OTC derivatives dealer's internal risk management control system shall include the following elements:

(1) A risk control unit that reports directly to senior management and is independent from business trading units;

(2) Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer;

(3) Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the OTC derivatives dealer's risk management systems;

(4) Definitions of risk, risk monitoring, and risk management; and

(5) Written guidelines, approved by the OTC derivatives dealer's governing body, that include and discuss the following:

(i) The OTC derivatives dealer's consideration of the elements in paragraph (b) of this section;

(ii) The scope, and the procedures for determining the scope, of authorized activities or any nonquantitative limi-

tation on the scope of authorized activities;

(iii) Quantitative guidelines for managing the OTC derivatives dealer's overall risk exposure;

(iv) The type, scope, and frequency of reporting by management on risk exposures;

(v) The procedures for and the timing of the governing body's periodic review of the risk monitoring and risk management written guidelines, systems, and processes;

(vi) The process for monitoring risk independent of the business or trading units whose activities create the risks being monitored;

(vii) The performance of the risk management function by persons independent from or senior to the business or trading units whose activities create the risks;

(viii) The authority and resources of the groups or persons performing the risk monitoring and risk management functions;

(ix) The appropriate response by management when internal risk management guidelines have been exceeded;

(x) The procedures to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;

(xi) The procedures requiring the documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;

(xii) The procedures authorizing specified employees to commit the OTC derivatives dealer to particular types of transactions;

(xiii) The procedures to prevent the OTC derivatives dealer from engaging in any securities transaction that is not permitted under § 240.15a-1; and

(xiv) The procedures to prevent the OTC derivatives dealer from improperly relying on the exceptions to § 240.15a-1(c) and § 240.15a-1(d), including the procedures to determine whether a counterparty is acting in the capacity of principal or agent.

(d) Management must periodically review, in accordance with written procedures, the OTC derivatives dealer's business activities for consistency with

## § 240.15c3-5

risk management guidelines including that:

(1) Risks arising from the OTC derivatives dealer's OTC derivatives activities are consistent with prescribed guidelines;

(2) Risk exposure guidelines for each business unit are appropriate for the business unit;

(3) The data necessary to conduct the risk monitoring and risk management function as well as the valuation process over the OTC derivatives dealer's portfolio of products is accessible on a timely basis and information systems are available to capture, monitor, analyze, and report relevant data;

(4) Procedures are in place to enable management to take action when internal risk management guidelines have been exceeded;

(5) Procedures are in place to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;

(6) Procedures are in place to identify and address any deficiencies in the operating systems and to contain the extent of losses arising from unidentified deficiencies;

(7) Procedures are in place to authorize specified employees to commit the OTC derivatives dealer to particular types of transactions, to specify any quantitative limits on such authority, and to provide for the oversight of their exercise of such authority;

(8) Procedures are in place to prevent the OTC derivatives dealer from engaging in any securities transaction that is not permitted under § 240.15a-1;

(9) Procedures are in place to prevent the OTC derivatives dealer from improperly relying on the exceptions to § 240.15a-1(c) and § 240.15a-1(d), including procedures to determine whether a counterparty is acting in the capacity of principal or agent;

(10) Procedures are in place to provide for adequate documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;

(11) Personnel resources with appropriate expertise are committed to implementing the risk monitoring and risk management systems and processes; and

## 17 CFR Ch. II (4-1-13 Edition)

(12) Procedures are in place for the periodic internal and external review of the risk monitoring and risk management functions.

[63 FR 59400, Nov. 3, 1998]

### § 240.15c3-5 Risk management controls for brokers or dealers with market access.

(a) For the purpose of this section:

(1) The term *market access* shall mean:

(i) Access to trading in securities on an exchange or alternative trading system as a result of being a member or subscriber of the exchange or alternative trading system, respectively; or

(ii) Access to trading in securities on an alternative trading system provided by a broker-dealer operator of an alternative trading system to a non-broker-dealer.

(2) The term *regulatory requirements* shall mean all federal securities laws, rules and regulations, and rules of self-regulatory organizations, that are applicable in connection with market access.

(b) A broker or dealer with market access, or that provides a customer or any other person with access to an exchange or alternative trading system through use of its market participant identifier or otherwise, shall establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity. Such broker or dealer shall preserve a copy of its supervisory procedures and a written description of its risk management controls as part of its books and records in a manner consistent with § 240.17a-4(e)(7). A broker-dealer that routes orders on behalf of an exchange or alternative trading system for the purpose of accessing other trading centers with protected quotations in compliance with Rule 611 of Regulation NMS (§ 242.611) for NMS stocks, or in compliance with a national market system plan for listed options, shall not be required to comply with this rule with regard to such routing services, except with regard to paragraph (c)(1)(ii) of this section.

(c) The risk management controls and supervisory procedures required by